



City of Rockville

MEMORANDUM

April 24, 2007

TO: Mayor and Council

VIA: Scott Ullery, City Manager

FROM: Gavin Cohen, Director of Finance

SUBJECT: City Financial Management Policies (FMP)

Attached are the revised FMP. The **blue** represents the changes made based on direction of the Mayor and Council from the April 16th meeting.

The policies are important and they affect our decision making daily. They also work together and should not be viewed in isolation. CIP Paygo policies affect debt ratio policies and reserve policies affect rate-setting policies. Revenue policies impact budget policies and CIP policies impact the operating budget. We want to make sure that all components work smoothly together for uniformity and consistency. The key for the Mayor and Council is to ensure the City adheres to sound financial policies and practices, the policies represent Mayor and Council values, and provide sufficient guidance to staff on financial issues of concern to the Mayor and Council.

Below are some of the key decision areas to resolve as part of the upcoming work sessions.

| Decision Point | Staff Recommendation | Mayor and Council Direction |
|--|--|---|
| Should the FMP include a host of other financial related policies and procedures as suggested by Rich Gottfried? | Staff has not included items such as cash procedure policies, investment policy, purchasing procedures etc. etc. Staff has many of the policies and procedures as listed. If all were included, it would run several hundreds of pages and become unwieldy. These are the highest-level set of financial policies and we should maintain them as such. | Mayor and Council may direct staff to include these policies as part of the document. Mayor and Council can select which to include or exclude. Investment Policy Whistleblower Policy Document destruction Policy Anti-Fraud Policy Insurance Policies Fixed Asset Capitalization Policy Cash Procedure Policies Purchasing procedure Policies |
| Should the FMP include provisions for an Audit Committee, Investment Advisory Committee, Finance Committee as suggested by Rich Gottfried? | Staff has not included the addition of committees to the FMP. The committees if formed would be Mayor and Council appointed committees and Mayor and Council should articulate the benefit/value, need and mission of any committee that is formed. | Mayor and Council may direct staff to do research to provide additional information on what the functions and roles of the committees would be. Once the Mayor and Council decided to form a committee, it could then be incorporated within the FMP as applicable. |

| Decision Point | Staff Recommendation | Mayor and Council Direction |
|---|--|--|
| <p>Should enterprise funds be required to maintain reserves and at what level? This is a major parameter utilized when setting rates. Page 6 of 15.</p> | <p>Staff is recommending a 3-month or 90-day reserve. This would be consistent with what Mayor and Council approved for the water and sewer funds. The amount is of a sufficient size to be a real reserve without being too large that the fund accumulates unneeded funds.</p> | <p>Mayor and Council should direct staff as to yes or no on reserves and if yes how much. Other choices can be 30, 45, or 60 days, if 90 days is perceived as too much.</p> |
| <p>Should enterprise funds be tax supported as well as fee supported? This is a major parameter utilized when setting rates. Page 9 of 15 # 6.</p> | <p>Staff is recommending that the policy not change and that enterprise funds, subject to the current exemptions for competitiveness, remain as is. This will allow the enterprise funds to retain their integrity as separate businesses and specific fee for service funds. There would be less incentive to control costs if partially tax supported, and fewer resources would be available for traditional General Fund services and Paygo financing.</p> | <p>Mayor and Council should direct staff to retain current policy without changes or to subsidize the enterprise funds with general tax dollars, and rewrite this policy. Mayor and Council should articulate the conditions under which the subsidies would take place and the amount of the subsidies.</p> |
| <p>Should the minimum dollar threshold for CIP projects be raised to \$100,000 from \$25,000? Page 14 of 15 # III and VI.</p> | <p>Staff is recommending the threshold change so that only high dollar value items are included within the CIP. This has an impact on both the CIP and the operating budget. Borrowing is a big component of the CIP and we should try to exclude items for which it is not advisable to borrow money.</p> | <p>Mayor and Council should direct staff to change the threshold to a value that they feel comfortable with for including an item as a Capital Project.</p> |

Staff would be looking for final direction from the Mayor and Council at the work session to be held on Monday April the 30th when the operating budget is discussed.



MAYOR AND COUNCIL AGENDA

NO. 9

DEPT.: Finance
STAFF CONTACT: Gavin Cohen

DATE PREPARED: April 11, 2007
FOR MEETING OF: April 16, 2007

SUBJECT:

City's Financial Management Policies (Policies).

RECOMMENDATION:

Staff recommends that the Mayor and Council discuss and provide direction on the attached Policies.

DISCUSSION:

The FY'08 proposed budget was presented to the Mayor and Council on March 26th 2007. Included within the FY 08 budget is a comprehensive rewrite of the City's Financial Management Policies. The Policies are the Mayor and Council's Policies that provide guidance to staff for financial matters and ensure transparency and accountability of City financial transactions.

Staff believes that the Policies as are being recommended meet or exceed Best Financial Management Practices for local government entities.

PREPARED BY:

Gavin Cohen, Finance Director

4/11/2007
Date

APPROVE:

Scott Ullery, City Manager

4/11/07
Date

LIST OF ATTACHMENTS:

City Financial Management Policies (Previously Distributed)



City of Rockville

MEMORANDUM

March 19, 2007

TO: Scott Ullery, City Manager

FROM: Gavin Cohen, Director of Finance

SUBJECT: City Financial Management Policies

Included within the FY 08 budget is an overhaul of the City's Financial Management Policies (Policies). The Mayor and Council initially adopted these Policies in 1989, and they were last revised in 2001. The Policies can be found on pages 2-5 through 2-13 of the operating budget book. The Policies are formally adopted when the Mayor and Council adopt the operating budget.

Financial Management Policies serve as the foundation for any organization to promote long-term financial stability, sound internal controls, and promote stakeholders confidence in the organization. The policies serve as guidelines to staff for financial matters and they reflect prudent fiscal practices on behalf of the Mayor and Council. This is of particular importance in the public sector where we are guardians of the public's tax dollars, and we want to promote public confidence and transparency with the resources that are entrusted to us.

There is no one size fits all when it comes to determining what Policies are suitable for which community. Each community is different and has different priorities and values. In addition to providing the above listed benefits, a strong set of Policies that are followed, reflect well with the rating agencies, and consequently lower the City's cost of borrowing money. Following the Policy guidelines that are established is one of the best defenses against any charges against fiscal impropriety.

I have attached the Government Finance Officers Association (GFOA) recommended practice on this subject entitled "Adoption of Financial Policies (2001)" as well as an article produced by Fitch ratings entitled "The 12 Habits of Highly Successful Finance Officers".

I believe that the recommended Policies meet or exceed the guidelines established by GFOA, and comply with the majority of the Best Financial Management Practices for Governmental Issuers, as described by Fitch.

A brief summary of the major changes follows:

The highlights reflect just the major changes that are being recommended.

A Statement of Purpose and Objectives have been added to clearly articulate the need and purpose for the Mayor and Council to adopt a set of Policies. The Purpose articulates the benefits to be derived by the organization for adopting Policies and the objectives articulate the outcomes that will be achieved.

Operating Budget Policies

- Reinforces that the City should only utilize current resources to cover current appropriations and that fund balances should only be utilized for Capital and non-recurring expenses.
- Establishes accountability for managing of the budget.
- Establishes a regular reporting requirement to the Mayor and Council.
- Reinforces that appropriation authority is only good for one year before lapsing.
- Details authority for approving budget transfers.
- Sets criteria for when a new fund should be established.

Reserve Policies

- Sets Policies for the City's Enterprise funds, and City's Debt Service Fund.
- Formally establishes a contingency account within the operating budget.

Cash Management/Investment Policies

- Establishes responsibility for the position authorized to invest City funds.
- Establishes standards under which City funds are managed.
- Establishes a regular reporting requirement to the Mayor and Council.
- Provides a formula for how interest earnings are allocated to the City's various funds.

Accounting, Auditing, and Financial Reporting Policies

- Establishes the importance of providing financial information in a timely and useable format.
- Reinforces that the City will only utilize established Accounting standards with which to prepare its financial information.
- Establishes the benchmark for performance in terms of reporting and audits.
- Reinforces that the City will fully fund its retirement plans funding obligations.

Revenue and Expenditure Policies

- Establishes that the City needs a diversified revenue base to provide ongoing services.
- Reinforces that revenues should be estimated conservatively, and that one-time sources should not be used to balance the budget.
- Formally adopts Policies for User Fee recoveries, especially for recreation programs and use of facilities.

Debt Management Policies

- Establishes the importance of bond rating and some guidelines for what we should and should not be issuing debt for.
- Establishes the importance of analyzing the debt capacity of the City prior to any issuance.
- Reinforces that any Enterprise fund debt should be covered by rates set for enterprise fees.
- Establishes debt service coverage ratios for City's Enterprise funds.
- Establishes guidelines for Refinancings.

Capital Improvement Program Policies

- Establishes some clear guidelines for what should be included as part of the City's CIP.
- Raises the threshold to \$100,000 from \$25,000 for a project to be included.

Productivity Policies

- This entire section reinforces some of the financial values that are to be incorporated within the "Rockville Way" of doing business.

Financial Management Policies

Statement of Purpose

The financial integrity of our City government is of utmost importance. To discuss, write, and adopt a set of financial policies is a key element to maintaining this integrity. These financial management policies are designed to ensure the fiscal stability of the City of Rockville and to guide the development and administration of the annual operating and capital budgets, and debt program.

Written, adopted financial policies have many benefits, such as assisting the Mayor and Council and City Manager in the financial management of the City, saving time and energy when discussing financial matters, promoting public confidence, and providing continuity over time as Mayor and Council and staff members change. While these policies will be amended periodically, they will provide the basic foundation and framework for many of the issues and decisions facing the City. They will promote wise and prudent financial management while providing adequate funding of the services desired by the public while assisting in the City's stability, efficiency and effectiveness.

Objectives

1. To assist the Mayor and Council and City management by providing accurate and timely information on financial conditions pertinent to City operations.
2. To provide sound financial principles with which to guide the important decisions of the Mayor and Council and management which have significant fiscal impact.
3. To set forth operational principles that minimize the cost of government and financial risk, to the extent consistent with services desired by the public.
4. To enhance the policy-making ability of the Mayor and Council by providing accurate information on program costs.
5. To ensure the legal use of all City funds through a sound financial system and strong internal controls.
6. To employ revenue policies that prevent undue or unbalanced reliance on certain revenues, which distribute the costs of municipal services fairly, and which provide adequate funds to operate desired programs.

In order to meet these objectives, the City's policies are divided into eight general categories for ease of reference. These categories include 1) Operating Budget Policies 2) Reserve Policies 3) Cash Management/Investment Policies 4) Accounting, Auditing, and Financial Reporting Policies 5) Revenue and Expenditure Policies 6) Debt Management Policies 7) Capital Improvement Program Policies 8) Productivity Policies. It is recommended that all policies included in this document be adhered to.

OPERATING BUDGET POLICIES

Budgetary Practices

1- Operating Budget Practices:

At least one month before the preparation of the annual budget, the City Manager will meet with the Mayor and Council Members to review and deliberate all policy guidelines that may affect the proposed budget.

1. It is the City's policy to fund current year operating expenditures with current year revenues, inclusive of debt service. It is allowable for total expenditures to exceed revenues in a given year, however beginning fund balance can only be used to fund CIP or other "one-time" or non-recurring expenditures, as authorized by the Mayor and Council.

Financial Management Policies

— Continued —

2. The operating budget shall serve as the annual financial plan for the City. It will serve as the policy document of the Mayor and Council for implementing Council visions, goals and objectives. The budget shall provide the staff resources necessary to accomplish the Mayor and Council's determined service levels.
3. The City Manager shall annually prepare and present a proposed operating budget to the Mayor and Council at least two months before the beginning of each fiscal year; and Mayor and Council will adopt said budget no later than May 31 of each year. Funds may not be expended or encumbered for the following fiscal year until the budget has been adopted by the Mayor and Council.
4. Each department and division prepares its own budget for review by the City Manager. Budget accountability rests primarily with each department. The basic format of the budget shall identify programs within organizational structures. Programs are defined as specific services provided to the public, other departments or other organizations.
5. The budget is approved in the form of an appropriations ordinance after the Mayor and Council has conducted at least one advertised public hearing.
6. The Operating Budget is adopted at the fund level. During the year, it is the responsibility of the City Manager, Department Directors, and the Budget Office to administer the budget. The legal control, which the budget ordinance establishes over spending, is set up under Generally Accepted Accounting Principles. The City Manager has the authority to transfer budgeted amounts between departments within any fund, but changes in the total appropriation level for any given fund can only be enacted by the Mayor and Council through an amendment to the current appropriations ordinance.
7. The City will strive to adopt an annual General Fund budget in which expenditures, net of pay-as-you-go capital project contributions, do not exceed projected revenues.
8. The City Manager will submit budgetary reports for the Mayor and Council approval comparing actual revenues and expenditures with budgeted amounts quarterly.
9. As a management policy, budgetary control is maintained in the General, Special Revenue, and Enterprise Funds at the program level by the encumbrance of estimated purchase amounts prior to the release of purchase orders to vendors. Purchase orders that result in overruns of balances are not processed until sufficient appropriations are made available through approved intrafund transfers. Encumbered amounts at year-end are recorded as a reservation of fund balance and are reflected as an adjustment to the ensuing year's budget.
10. A five-year projection of revenues and expenditures for the General, Special Revenue, and Enterprise Funds is prepared each fiscal year to provide strategic perspective to each annual budget process.
11. All appropriations shall lapse at the end of the budget year to the extent that they shall not have been expended or encumbered.
12. Any year end operating surpluses will revert to fund balances for use in maintaining reserve levels set by policy, see policy's on page 6, and the balance will be available for pay-go capital projects and/or one time only capital outlay.

Budget Transfers

1. All budget transfers must receive approval by the Department Director, and Budget Office regardless of the budget transfer amount. In addition, any budget transfer over \$50,000 requires City Manager approval. City Manager approval is required for transfers from one department to another.
2. Approval of the budget transfer must be obtained prior to requisition, encumbrance or expenditure of funds taking place.

Interfund Transfers and Loans

1. Any interfund transfers between funds for operating purposes can only be made by the Director of Finance with City Manager approval in accordance with the adopted budget.

Financial Management Policies

— Continued —

2. These operating transfers, under which financial resources are transferred from one fund to another, are distinctly different from interfund borrowings, which are usually made for temporary cash flow reasons, and are not intended to result in a transfer of financial resources by the end of the fiscal year.
3. Interfund transfers result in a change in fund equity; interfund borrowings do not, as the intent is to repay the loan in the near term.

Financial Management Policies

— Continued —

Fund Structure:

- 2.1. The accounts of the City are organized into funds. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenue, and expenditures (or expenses, as appropriate).
- 3.2. Government resources are allocated to and accounted for in individual funds based on the purposes for which they are to be expended and the means by which spending activities are controlled. The City uses governmental funds and enterprise funds. Governmental funds are those through which most governmental functions of the City are financed. The acquisition, use, and balance of the City's expendable financial resources and the related liabilities (except for those accounted for in the enterprise funds) are accounted for through governmental funds.
3. The City's governmental funds are the General Fund, the Special Revenue Funds, the Capital Projects Fund, and the Debt Service Fund. The General Fund is the general operating fund of the City. It is used to account for all financial resources except those required to be accounted for in another fund. The Special Revenue Funds are used to account for the proceeds of specific revenue sources (other than major capital projects) that are restricted by legal and regulatory provisions or budgeted contributions from outside sources to financial specific activities. The City's Special Revenue Funds are the Special Activities Fund, and the Community Development Block Grant Fund, and Town Center Management Fund. The Capital Projects Fund is used to account for financial resources used for the acquisition or construction of major capital facilities and general capital construction, including streets, parks, and public buildings (other than those financed by enterprise funds). The Debt Service Fund, which includes special assessments, is used to account for the accumulation of resources for, and the payment of, general long-term debt principal, interest, and related costs.
4. The enterprise funds are the Water Facility Fund, the Sewer Fund, the Refuse Fund, the Parking Fund, the Stormwater Management Fund, and the RedGate Golf Course Fund. ~~The relationship between all of the funds of the City of Rockville is listed below. Specific details of each fund are located in the Fund Summaries section.~~

Governmental Funds:

General Fund

Special Revenue Funds:

Special Activities Fund

Community Development Block Grant Fund

Capital Projects Fund

Debt Service Fund

Enterprise Funds:

Water Facility Fund

Sewer Fund

Refuse Fund

Parking Fund

Stormwater Management Fund

RedGate Golf Course Fund

5. Creation of new funds should be based on the following criteria:

- I. ~~■~~ The revenue source is ongoing i.e. more than one fiscal year.
- II. ~~■~~ The amounts to be recorded are material.
- III. ~~■~~ Interest income is required to be allocated.
- IV. ~~■~~ The amounts are specifically designated.
- V. ~~■~~ There is another fund that can be used to account for the revenue source.
- VI. ~~■~~ There are special circumstances that have led management to create a separate fund?
- VII. If the state or federal government requires a separate fund to account for a particular source of revenue then such a fund can and must be created.

Financial Management Policies

— Continued —

3. Basis of Budgeting:

1. —Budgets for governmental and proprietary (or enterprise) funds are adopted on a basis consistent with Generally Accepted Accounting Principles. Accordingly, all governmental fund budgets are presented on the modified accrual basis of accounting, ~~and therefore, all unencumbered annual appropriations lapse at fiscal year end.~~ Under this method of accounting, revenue and other governmental fund resources are recognized in the accounting period in which they become susceptible to accrual — that is, when they become both “measurable and available” to finance current operating expenditures for the fiscal period.
2. In applying the susceptible to accrual concept to real and personal property tax revenue recognition, “available” means property tax revenue is recognized currently if levied before the fiscal ~~year end~~year end and collected by intermediaries within 60 days after the fiscal ~~year end~~year end. Utility and franchise fees, licenses and permits, fines and forfeitures, charges for services, and miscellaneous revenue (except investment earnings) are recorded as revenue when cash is received because they are generally not measurable until actually received. Investment earnings are recorded as earned since they are both measurable and available.
3. For grant revenue such as the Community Development Block Grant (CDBG) program, which is dependent upon expenditures by the City, revenue is accrued when the related expenditures are incurred. Expenditures are generally recognized under the modified accrual basis of accounting when the related fund liability is incurred. An exception to this general rule is principal and interest on general long-term debt which are recognized when due.
4. The enterprise fund budgets are presented on the full accrual basis of accounting. Under this method of accounting, revenue is recognized when earned and expenses are recognized when they are incurred. For example, earned but unbilled utility revenues are accrued and reported in the financial statements. Enterprise fund capital purchases are budgeted in the operating budget and recorded as expenses during the year; at ~~year end~~year end, they are capitalized for financial statement purposes.

Financial Management Policies

— Continued —

RESERVE POLICIES

The City utilizes a variety of funds for recording the revenue and expenditures of the City. At each fiscal year end, operating surpluses that revert to fund balance over time constitute available reserves of the City.

General Fund

1. The City will maintain an unreserved undesignated General Fund fund balance at a level not less than 15 percent of annual General Fund revenue. ~~The reduction of the fund balance from its current required level of 25 percent (as of 1998, for the FY 1999 budget) will take place in annual increments of five percent, as provided for in the City's Long-Range Fiscal Analysis. The reduction of fund balance dollars will be used for pay-as-you-go financing for capital improvements or for other one-time capital items.~~ The purpose of this unreserved balance is to alleviate significant unanticipated budget shortfalls and to ensure the orderly provisions of services to residents. This is the minimum level necessary to maintain the City's credit worthiness and maintain adequate cash flows. Use of these funds below the required level must be approved by specific action of the Mayor and Council.
2. To the extent that unreserved General Fund fund balance exceeds the target, the City ~~may~~ will draw upon the fund balance to provide pay-as-you-go financing for capital projects or for other one-time capital items.
3. The Mayor and Council may designate parts of the available fund balance that would represent tentative management plans rather than actual restrictions on the use of resources.

Enterprise Funds

The City will maintain as reserves working capital balances of 90 days of operating expenses. In addition the water and sewer funds will maintain a repair, renewal, replacement reserve of a maximum of 1% of the book value of assets.

Enterprise funds with a negative cash balance, should develop plans that will allow the fund to show a positive cash balance within five years, and rates and fees should be set accordingly.

~~The City's General Fund is implicitly subsidizing funds with negative cash balances.~~

Debt Service Fund

The City will maintain a minimum balance equal to the maximum annual debt service for any year on the City's debt service schedule.

General Fund contingency account

A contingency account equal to a maximum of 1% of the City's General Fund budgeted appropriations will be maintained annually in the non-departmental budget. This account will be available for unanticipated, unbudgeted expenditures of a non-recurring nature and/or to meet unexpected cost increases, and will require City Manager approval to spend. All spending from the contingency account shall be reported to the Mayor and Council quarterly.

Financial Management Policies

— Continued —

CASH MANAGEMENT/INVESTMENT POLICIES

1. Investments and cash management will be the responsibility of the Director of Finance.
2. City funds will be managed in accordance with the prudent person standard with the emphasis on safety of principal, liquidity, and yield, in that order.
3. Investments of the City will be made in accordance with the City's adopted Investment Policy.
4. The City is authorized to invest in any and all types of investments, as described in State Finance and Procurement Article 6-222(a) or Article 95, section 22-22N of the Annotated Code of Maryland, except where specifically prohibited by Maryland statutes. ~~Permissible investments are federal obligations, including repurchase agreements supported by federal obligations.~~
5. The City will diversify use of investment instruments to avoid incurring unreasonable risks inherent in over-investing in specific instruments, individual financial institutions, or maturities.
6. The Director of Finance shall present reports of the City's investments and cash position monthly to the Mayor and Council.
7. ~~4.~~ All cash is combined into one pooled operating account to facilitate effective management of the City's resources, and to maximize yield from the overall portfolio.
8. Interest earnings shall get allocated to funds with a positive cash balance based on the average of the past six months cash balances by fund.

Financial Management Policies

— Continued —

ACCOUNTING, AUDITING, AND FINANCIAL REPORTING POLICIES

Accounting, Auditing, and Reporting Practices

1. It will be the policy of the City of Rockville to provide all financial information in a thorough, timely fashion and in a format that is easy for the Mayor and Council, Citizens, Committees and City employees to understand and utilize.
2. The City's accounting finance systems will be maintained in accordance with Generally Accepted Accounting Principles (GAAP) as promulgated by the Government Accounting Standards Board (GASB).
- ~~1.3.~~ The basis of accounting within governmental fund types used by the City of Rockville is modified accrual as well as the "current resource measurement focus." Under this method of accounting, revenue is recorded when susceptible to accrual, such as when measurable and available for the funding of current appropriations. All enterprise funds follow the accrual basis of accounting, as well as the "capital maintenance measurement focus." Under this method of accounting, revenues are recognized when earned, as billed and unbilled, and expenses are recorded when incurred.
- ~~2.4.~~ The City places continued emphasis on maintenance of an accounting system which provides strong internal budgetary and accounting controls designed to provide reasonable, but not absolute, assurances regarding both the safe-guarding of assets against loss from unauthorized use or disposition and the reliability of financial records for preparing financial statements and reports, such as the budget and the *Comprehensive Annual Financial Report (CAFR)* as well as the maintenance of accountability of assets.
- ~~3.5.~~ An independent audit of the City of Rockville is performed annually. The auditor's opinion will be included in the City's CAFR. The City will strive for an unqualified auditor's opinion.
6. An independent audit firm will be selected through a competitive process at least once every five years. The audit contract will be awarded by the Mayor and Council upon the recommendation of the City Manager and Director of Finance.
7. 4-The City of Rockville issues a *Comprehensive Annual Financial Report* in accordance with Generally Accepted Accounting Principles outlined by the Governmental Accounting Standards Board, within four months of the close of the previous fiscal year. It will be presented to the Mayor and Council within six months at a regularly scheduled City Council meeting. The CAFR will be submitted annually to GFOA for peer review as part of the *Certificate of Achievement for Excellence in Financial Reporting* program. All reports prepared by the auditors, and managements response to those reports will be presented to the Mayor and Council at a regularly scheduled Council meeting within six months of the fiscal year end.
8. The City offers its employees a defined benefit pension plan and a defined contribution pension plan. The plans are administered by the Retirement Board comprised of a seven member whose members are appointed by the Mayor and Council to serve two-year terms.
9. The retirement plans do not issue separate financial statements, but plans shall be included as part of the City's financial statements and accordingly be subjected to an annual audit.
10. The City's annual contribution toward the pension plans shall be determined by an independent actuary and published as an annual actuarial report. The City will annually meet its obligation to funding its share of the pension plan contribution out of its operating budget.

Revenue and Expenditure, Capital Financing, and Debt Management Policies

~~In June 1989, the Mayor and Council adopted a set of fiscal policies regarding the projection of revenues and expenditures, capital financing, and debt management. As part of the FY 1999 budget process, the Mayor and Council reviewed these policies. The Mayor and Council adopted the revised policies, listed below, in May 2001. The introduction of the Capital Improvements Program provides details of the City's compliance with the Capital Financing and Debt Management Policies; see page 5 in the CIP overview section.~~

Financial Management Policies

— Continued —

REVENUE AND EXPENDITURE POLICIES

Revenue and Expenditure Policies

1. The City will strive to develop and maintain a diversified and stable revenue stream so as to avoid becoming overly dependent on any single type of revenue to minimize the effects of economic fluctuations on revenues and ensure its ability to provide for ongoing services.
2. Budgeted revenues shall be estimated conservatively using accepted standards and estimates provided by the State, County and other governmental agencies when available.
3. Revenue from "one-time" or limited duration sources will not be used to balance the City's operating budget.
4. As appropriate within the marketing of the recreation programs, higher non-resident fees may be charged and priority registration will be given to Rockville residents.
5. Restricted revenue shall only be used for the purposes legally permissible and in a fiscally responsible manner.
- ~~1. The City will strive to adopt an annual General Fund budget in which expenditures, net of pay as you go capital project contributions, do not exceed projected revenues.~~
- ~~2. A five-year projection of revenues and expenditures for the General, Enterprise, and Debt Service Funds is prepared each fiscal year to provide long-range, strategic perspective to each annual budget process.~~
- ~~3-6.~~ On an annual basis the City will set fees and rates for the enterprise funds at levels which fully cover total direct and indirect operating costs, and all capital outlay and debt service, except where the City is not the sole provider of the service and competitive rates must be taken into consideration. In these instances, fees and rates must at least cover all direct and indirect operating expenses.
7. The City shall actively pursue federal, state, county and other grant opportunities when deemed appropriate. Before accepting the grant, the city shall thoroughly consider the implications in terms of ongoing obligations, indirect costs and matching requirements in connection with the grant.
8. Gifts, bequests and donations will be evaluated to determine what, if any, obligations are to be placed upon the City. Gifts, bequests and/or donations shall be used solely for the purpose intended by the donor.

User Fee Cost Recovery Goals

Fees for services will be reviewed and updated on an ongoing basis to ensure that they keep pace with inflation. In addition, fees need to be updated for changes in methods or levels of service delivery to ensure that they are appropriate and equitable for all users.

In order to implement this goal, a comprehensive analysis of City costs and fees should be undertaken at least every five years. In the interim, fees will be adjusted by annual changes in the Consumer Price Index (CPI). Fees may be adjusted during this interim period based on supplemental analysis whenever there have been significant changes in the method, or level of cost of service delivery.

General Concepts to be followed are:

- Revenues should not exceed the reasonable cost of providing the service.
- Cost recovery goals should be based on the total cost of delivering the service, including direct costs, indirect costs, departmental administration costs, and organization-wide support costs such as accounting, personnel, IT, insurance etc.
- The method of assessing and collecting fees should be as simple as possible in order to reduce the administrative cost of collection.
- Rate structures should be sensitive to the "market" for similar services as well as to smaller, infrequent users of the service.

Financial Management Policies

— Continued —

Development Review Programs

Services under this category include Planning, Building and Safety, and Engineering. Cost recovery goal for these services in most instances should be 100%. However in charging at this level, the City needs to clearly establish and articulate standards for its performance in reviewing developer applications to ensure that there is "value for cost".

Recreation and Park Programs

Fees are reviewed and annually by the Recreation and Parks Advisory Board. The fees that fall into this category are user fees of public recreation facilities and programs, rental fees for use of public grounds and facilities, admission fees for public events, special service fees for extraordinary items, vendor fees for the privilege of selling goods and services on public property, and development review fees associated with the Forest and Tree Preservation ordinance. In addition to these fees, grants and other financial contributions from businesses and other levels of government support recreation and parks programs.

The level of cost recovery is based on different service levels provided throughout the community as follows:

Basic Services, Parks and Facilities

Services include operation and maintenance of parks, open space and recreation facilities, neighborhood and City-wide parks, greenways, trails, rights-of-way islands and landscaping including street trees, playgrounds, non-reservation amenities and other similar public facilities, maintenance operations facilities, as well as overall department administrative activities. These improvements primarily serve to support individual and small-group non-reserved/non-consumptive/non facility-based amenities and recreation activities.

No cost recovery is associated with these functions. These services are provided to the community with funds derived from tax revenues.

These activities include by are not limited to:

| | |
|------------------------------|--|
| * Parks | * Hiking |
| * Playgrounds | * Walking |
| * Picnic areas | * Fishing |
| * Trails | * Picnicking |
| * Bike paths | * Biking |
| * R-o-w landscaping | * Play |
| * Facility landscaping | * Nature observation |
| * Urban forestry maintenance | * Trail and pathway activities |
| * Outdoor courts | * Informal games |
| * Undesignated play areas | * City uses for activities, meetings, etc. with no associated revenue. |
| * Dog Park | |

Community Benefit – Core Programs, Services and Facilities

Services include core or basic recreation programs, activities and events which utilize parks, recreation facilities and other public spaces, providing benefits to the entire community or a large portion thereof, are not routinely provided by the private sector and are partially supported by fees and charges. These are considered to provide a baseline level of service and can be considered to enhance the quality of life for Rockville residents.

Financial Management Policies

— Continued —

Community Benefit programs and facility uses are expected to recover approximately 25% of direct costs, from fees, sponsorships and grants. Supplemental funding is provided via tax dollars.

These activities include by are not limited to:

- | | |
|---|----------------------------------|
| * Civic Association/HOA uses of their neighborhood community center | |
| * Drop-in use of facilities such as Civic Center, recreation centers, community centers, Senior Center, Nature Center | |
| * City-Wide special events including Memorial Day Parade and Independence Day, Town Center Festivals | |
| * At-risk youth programs | * Senior Social Services |
| * Basic after-school programs | * Senior transportation services |
| * Outdoor performing arts series | * Community special events |
| * Art galleries | * Farmers Market |
| * Therapeutic recreation programs | * Grant supported programs |
| * Teen social clubs and dances | * Seasonal programs and events |

Community/Individual Benefit Services

These services provide benefits that accrue both to the community at large as well as to the individual served. They are available to all, however space, time, consumptive use, cost of supply and other factors may limit or preclude participation. On occasion the private sector, in particular non-profits, may offer some of these services. Due to the limitations listed above and especially to "cost of supply" circumstances, these services have been designated to recover a substantial percentage of direct and indirect costs. In some special circumstances, full cost recovery may be warranted.

Community/Private Benefit programs and facility uses are expected to recover between 25% and 100% of direct costs and up to 25% of indirect costs. Supplemental funding is provided as necessary and appropriate via tax dollars.

These activities include but are not limited to:

- * Introductory or basic skill level activities of all types for all ages.
- * Swim Center facility and program use (memberships, daily admissions, classes, swim team, etc.)
- * City-wide special Events – Hometown Holidays concerts, Eggstravaganza, Car Show, road races,
- * Adult sports leagues
- * Youth sports leagues, including partner non-profit leagues
- * Recreation/Community center programs and rentals
- * Skate Park
- * Summer Playgrounds
- * Senior Citizen recreation programs
- * Senior Citizen sports and fitness programs
- * Concert Band, Community Chorus, RRYO, Civic Ballet
- * Resident Companies at F. Scott Fitzgerald Theater

Financial Management Policies

— Continued —

Individual Benefit Services

These services are defined as those products/processes for which benefits accrue almost entirely to the individual, group or organizational participant/consumer. They may be available to the entire City population or beyond, but substantial limitations on space, time consumption and cost have the effect of restricting use. The private sector can supply these services or they are provided through public/private partnerships. Due to "cost of supply" factors these services are required to fully recoup direct costs, up to 100% of indirect costs, and in some cases a pro-rata share of allocated costs. Fees are often established based on the appropriate local market demand.

Private Benefit programs and facility uses are expected to recover 100% of direct costs, up to 100% of indirect costs and in some cases a portion of allocated costs. Tax supported funding is minimal.

These activities include but are not limited to:

- * Fitness facilities within recreation centers, RMSC, Senior Center, etc.
- * Licensed childcare programs
- * Intermediate and advanced skill development activities for youth and adults
- * Trips and tours – all ages
- * Outdoor adventure activities
- * Summer Camps – all types
- * Advanced or Select-level team sports for youth and adults
- * Private use/rentals of City facilities
- * Retail sales/concessions

Financial Management Policies

— Continued —

DEBT MANAGEMENT POLICIES

Capital Financing and Debt Management Policies

1. Debt management will provide for the protection of bond rating, the maintenance of adequate debt service reserves, compliance with debt covenant provisions and appropriate disclosure to investors, underwriters and rating agencies.
2. The term of any City debt issue shall not exceed the useful life of the assets being acquired by the debt issue.
3. All debt issuance shall comply with Federal, State and City charter requirements and adherence to Federal arbitrage regulations.
4. The City shall maintain an ongoing performance monitoring system of the various outstanding bond indebtedness issues and utilize this monitoring system as a performance criterion for the administration of the City's outstanding indebtedness. This is particularly important as funds borrowed for a project today are not available to fund other projects tomorrow and funds committed for debt service payments today are not available to fund operations in the future.
5. The City will maintain good, ongoing communications with bond rating agencies about its financial condition. The City will follow a policy of full disclosure on every financial report and bond prospectus (Official Statement).
6. Accompanying each debt issue will be an assessment of the City's capacity to repay the debt. The assessment will address the effects on the current operating budget, as well as identify the resources that will be utilized to repay the debt.
- ~~1-7.~~ Long-term borrowing will not be used to finance current operations or normal maintenance and will only be considered for significant capital and infrastructure improvements.
8. The City will try to keep the average maturity of general obligation bonds at or below twenty years.
9. The City will generally conduct financings on a competitive basis. However, negotiated financings may be used due to market volatility or the use of an unusual or complex financing or security structure.
- ~~2-10.~~ All debt issued, including by lease-purchase methods, will be repaid within a period not to exceed the expected useful lives of the improvements financed by the debt.
- ~~3-11.~~ The City will not issue tax or revenue anticipation notes.
- ~~4-12.~~ The City will strive to maintain a high reliance on pay-as-you-go financing for its capital improvements.
- ~~5-13.~~ The City will maintain its net tax-supported debt at a level not to exceed 1.0 ~~0.8~~ percent of the assessed valuation of taxable property within the City.
- ~~9-14.~~ The City will strive to ensure that its net tax-supported debt per capita does not exceed \$700. The City will strive to ensure that the combined total of its direct net bonded debt and its attributed share of overlapping debt issued by Montgomery County does not exceed \$2,000 per capita.
- ~~10-15.~~ The City will strive to ensure that its net tax-supported debt per capita as a percentage of federal adjusted gross income does not exceed two and one-half percent.
- ~~11-16.~~ The City will maintain its annual net tax-supported debt service costs at a level less than 15 percent of the combined expenditure budgets (net of interfund transfers) for the General, Special Revenue, and Debt Service Funds.
17. The City will set enterprise fund rates at levels needed to fully cover debt service requirements as well as operations, maintenance, administration and capital improvement costs. The ability to afford new debt for enterprise operations will be evaluated as an integral part of the City's rate review and setting process.
18. Debt service coverage ratios will be calculated annually for all of the City's enterprise funds. A minimum of 1.2 needs to be maintained for each of the enterprise funds.

Financial Management Policies

— Continued —

Refinancing

1. Periodic reviews of all outstanding debt will be undertaken to determine refinancing opportunities. Refinancings will be considered (within federal tax law constraints) under the following conditions:

I. There is a net economic benefit.

In general, refinancings for economic savings will be undertaken whenever net present value savings of at least 5% of the refunded debt can be achieved.

Refinancings that produce net present value savings of less than 5% will be considered on a case-by-case basis, provided that the present value savings are at least 3% of the refunded debt.

Refinancings with savings of less than 3%, will not be considered unless there is a compelling public policy objective.

II. It is needed to modernize covenants that are adversely affecting the City's financial position or operations.

III. The City wants to reduce the principal outstanding in order to achieve future debt service savings, and it has available working capital to do so from other sources.

CAPITAL IMPROVEMENT PROGRAM (CIP) POLICIES

~~Capital Improvements Program (CIP) Practices:~~ Along ~~W~~with the operating budget, the City Manager submits a CIP to the Mayor and Council. This document provides for improvements to the City's public facilities for the ensuing fiscal year and ~~four~~ five years thereafter. The first year of the plan establishes a capital budget for the new fiscal year. The remaining ~~four~~ five years serve as a guide for use in determining probable future debt issuance needs and operating cost impacts. *The Capital Budget is adopted at the fund level.* CIP expenditures are accounted for in the Capital Projects Fund or the appropriate enterprise funds and are funded by a variety of sources. The City strives to maintain a high reliance on "pay-as-you-go" financing for its capital improvements in order to maintain debt within prudent limits, and to ensure that the rates charged in the enterprise funds are competitive with those in the surrounding area. ~~For projects to be included within the CIP, they should normally be eligible for debt financing, and have a defined beginning and end, as differentiated from ongoing programs in the operating budget. The City's most recent bond ratings received with general obligations issued in 2001 are "Aa1" issued by Moody's Investors Service and a Standard and Poor's rating of "AA+"; both are considered enviable ratings.~~

To qualify as a CIP project, one of the following six criteria must be met:

- I. The acquisition of land for a public purpose.
- II. The construction of a significant facility, i.e. a building or road, or the addition to or extension of an existing facility.
- III. Nonrecurring rehabilitation or major repair to all or part of a facility, such as infrequent repairs that are not considered to be recurring maintenance, provided the total cost per fiscal year is more than \$25,000, \$100,000.
- IV. Any specific planning, engineering study, or design work related to an individual project falling within the above three categories.
- V. Any long-term project funded through a grant where the establishment of a CIP project is a condition of the grant, regardless of the amount of funding per fiscal year.
- VI. A significant one-time investment in tangible goods of any nature, the benefit of which will accrue over a multi-year period such as a new phone system or vehicle acquisitions over \$25,000 \$100,000.

Financial Management Policies

— Continued —

1. Annually, a five ~~six~~-year Capital Improvements Program (CIP) plan will be developed analyzing all anticipated capital expenditures by year and identifying associated funding sources. The plan will also contain projections of how the City will perform over the five ~~six~~-year period in relation to the fiscal policies that refer to debt ratios.
2. The first year of the five ~~six~~-year (CIP) and any unspent funds from prior years will be appropriated as part of the annual budget process. The CIP will be appropriated by fund. At least semi-annually, the City Manager will notify the Council of any transfers between projects within a fund.
3. The City will maintain a Capital Projects Monitoring Committee composed of City staff, which will meet not less than once every six months to review the progress on all outstanding projects as well as to revise spending projections. Each CIP project will have a project manager who will prepare the project proposal sheet, ensure that project is completed on schedule, authorize all project expenditures, and ensure that all regulations and laws are observed. Project managers will be responsible for reporting project status to the committee.
4. If new project appropriation needs are identified at an interim period during the fiscal year, at the fund level, the appropriations ordinance will be utilized to provide formal budgetary authority for the increase. Any significant impact resulting from the change on the overall CIP and on the debt ratios will be indicated at that time.
5. The City shall actively pursue outside funding sources for all projects for the CIP funding, where practical to do so.
6. Capital Projects shall be prioritized according to goals set by the Mayor and Council.
7. Unexpended project appropriations may be transferred to other projects within the same funding source with the approval of the City Manager.
- 5-8. Each year, a closing resolution will be submitted to the Mayor and Council to obtain formal authorization to close completed capital projects. The unexpended appropriations for these projects will be returned to the fund from which the appropriations were made. A report showing the amounts budgeted, expended, transferred and unexpended returning to fund balance shall be provided.

PRODUCTIVITY

Fiscal responsibility and accountability to the community are two values embodied within the "ROCKVILLE WAY" of providing premium services to the community. To this end, the City will constantly monitor and review our methods of operation to ensure that services continue to be delivered in the most cost effective manner possible. This review process encompasses a wide range of productivity issues, including:

- I. Analyzing systems and procedures to identify and remove unnecessary review requirements.
- II. Evaluating the ability of new technologies and related capital investments to improve productivity.
- III. Developing the skills and abilities of all City employees.
- IV. Developing and implementing appropriate methods of recognizing and rewarding exceptional employee performance.
- V. Evaluating the ability of the private sector to perform the same level of service at a lower cost.
- VI. Periodic formal reviews of operations on a systematic ongoing basis.
- VII. Encouraging accountability by delegating responsibility to the lowest possible level.
- VIII. Stimulating creativity, innovation and individual initiative.
- IX. Improving the organization's ability to respond to changing needs, and identify and implement cost-saving programs.
- X. Assigning responsibility for effective operations and citizen responsiveness to the department.



RECOMMENDED PRACTICE

Adoption of Financial Policies (2001)

Background. The National Advisory Council on State and Local Budgeting (NACSLB) has developed a comprehensive set of recommended budget practices. The recommendations have been endorsed by a number of key governmental associations, by academia and by labor groups associated with state and local governments. These practices and the associated framework outline a budget process that encompasses the broad scope of governmental planning and decision-making with regard to the use of resources. This work is recognized as one of the most important advances in governmental finance in decades. The Government Finance Officers Association (GFOA) has adopted a recommended practice endorsing the NACSLB practices and the associated framework. However, the policies included in this Recommended Practice are those considered fundamental to the budget process and relevant to the broadest number of jurisdictions.

The work of the NACSLB provides a framework for describing the overall budget process. The framework is organized around the four principles of the budget process:

- Establish Broad Goals to Guide Government Decision Making
- Develop Approaches to Achieve Goals
- Develop a Budget Consistent with Approaches to Achieve Goals
- Evaluate Performance and Make Adjustments

Each of these principles has additional elements that provide guidance for an effective budget process. Element #4, of Principle 2, Adopt Financial Policies, addresses the need for jurisdictions to establish policies to help frame resource allocation decisions.

Recommendation.

The Government Finance Officers Association (GFOA) recommends that, at a minimum, financial policies in the following areas be developed by professional staff and formally adopted by the jurisdiction's governing board *as well as the governing boards of those component units; state, provincial and municipal corporations and organizations; and other bodies under their jurisdiction.*

- Financial Planning Policies
- Revenue Policies
- Expenditure Policies

The jurisdiction's adopted financial policies should be used to frame major policy initiatives and be summarized in the budget document.

It is further recommended that these policies, along with any others that may be adopted, be reviewed during the budget process. Professional staff should review the policies to ensure continued relevance and to identify any gaps that should be addressed with new policies. The results of the review should be shared with the governing board during the review of the proposed budget.

Policy categories that should be considered for development, adoption and regular review are as follows: Financial Planning Policies

These policies address both the need for a long-term view and the fundamental principle of a balanced budget. At a minimum, jurisdictions should have policies that support:

1. **Balanced Budget** - A jurisdiction should adopt a policy(s) that defines a balanced operating budget, encourages commitment to a balanced budget under normal circumstances, and provides for disclosure when a deviation from a balanced operating budget is planned or when it occurs. (NACSLB Practice 4.5)
2. **Long-Range Planning** - A jurisdiction should adopt a policy(s) that supports a financial planning process that assesses the long-term financial implications of current and proposed operating and capital budgets, budget policies, cash management and investment policies, programs and assumptions. (NACSLB Element 9, GFOA Recommended Practice)¹
3. **Asset Inventory** - A jurisdiction should adopt a policy(s) to inventory and assess the condition of all major capital assets. This information should be used to plan for the ongoing financial commitments required to maximize the public's benefit. (NACSLB Practice 2.2)²

Revenue Policies

Understanding the revenue stream is essential to prudent planning. Most of these policies seek stability to avoid potential service disruptions caused by revenue shortfalls. At a minimum jurisdictions should have policies that address:

1. **Revenue Diversification** - A jurisdiction should adopt a policy(s) that encourages a diversity of revenue sources in order to improve the ability to handle fluctuations in individual sources. (NACSLB Practice 4.6)
2. **Fees and Charges** - A jurisdiction should adopt policy(s) that identify the manner in which fees and charges are set and the extent to which they cover the cost of the service provided. (NACSLB Practice 4.2)

¹ See also GFOA's recommended practice on *Establishment of Strategic Plans* (2005).

² See also GFOA's recommended practice on *Sustainability* (2002).

3. Use of One-time Revenues - A jurisdiction should adopt a policy(s) discouraging the use of one-time revenues for ongoing expenditures. (NACSLB Practice 4.4)

4. Use of Unpredictable Revenues - A jurisdiction should adopt a policy(s) on the collection and use of major revenue sources it considers unpredictable. (NACSLB Practice 4.4a)

Expenditure Policies

The expenditures of jurisdictions define the ongoing public service commitment. Prudent expenditure planning and accountability will ensure fiscal stability. At a minimum jurisdictions should have policies that address:

1. Debt Capacity, Issuance, and Management - A jurisdiction should adopt a policy(s) that specifies appropriate uses for debt and identifies the maximum amount of debt and debt service that should be outstanding at any time. (NACSLB Practice 4.3, 4.3a, GFOA Recommend Practices pp.90-92)

2. Reserve or Stabilization Accounts - A jurisdiction should adopt a policy(s) to maintain a prudent level of financial resources to protect against the need to reduce service levels or raise taxes and fees due to temporary revenue shortfalls or unpredicted one-time expenditures. (NACSLB Practice 4.1)³⁴

3. Operating/Capital Expenditure Accountability - A jurisdiction should adopt a policy(s) to compare actual expenditures to budget periodically (e.g., quarterly) and decide on actions to bring the budget into balance, if necessary. (NACSLB Practice 7.2)

References.

- National Advisory Council on State and Local Budgeting. *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting*. GFOA 1998.
- *A Guide for Preparing a Debt Policy*, Patricia Tigue, GFOA, 1998.
- GFOA Recommended Practice. "Setting of Government Charges and Fees" (1996).
- "Elements of a Comprehensive Local Debt Policy," *Government Finance Review*, October 1994.
- "Developing Formal Debt Policies," *Government Finance Review*, August 1991.

³ See also GFOA's recommended practice on *Business Preparedness and Continuity Guidelines* (2005).

⁴ See also GFOA's recommended practice on *Appropriate Level of Unreserved Fund Balance in the General Fund* (2002).

Criteria Report

The 12 Habits of Highly Successful Finance Officers Management's and Disclosure's Impact on Municipal Credit Ratings

Analysts

David Litvack
1 212 908-0593
david.litvack@fitchratings.com

West Region

Amy Doppelt
1 415 732-5612
amy.doppelt@fitchratings.com

Northeast Region

Jessalynn Moro
1 212 908-0608
jessalynn.moro@fitchratings.com

Southeast Region

Amy Laskey
1 212 908-0568
amy.laskey@fitchratings.com

Midwest Region

Adrienne Booker
1 312 368-5471
adrienne.booker@fitchratings.com

Joseph O'Keefe
1 312 368-3171
joseph.okeefe@fitchratings.com

Fitch Ratings would like to acknowledge Janet Rosen for her contribution to this report.

■ Summary

In 1999, Fitch Ratings undertook a study of defaults of municipal debt, which resulted in the revision of its rating criteria for many sectors of public finance. During that process, Fitch came to the conclusion that management practices were more important in predicting favorable credit performance than had been appreciated in the past. Fitch's public finance group identified several preferred management practices and said on record that issuers who incorporate several of these best practices could see a difference of one to three rating notches above the ratings of similar issuers that do not incorporate such practices. In the subsequent review of Fitch's entire portfolio of debt ratings that occurred through 2000, many ratings were revised under the new criteria. Fitch changed about 27% of its tax-supported debt ratings and about half its water and sewer ratings, mostly upgrades. Fitch estimates that about three-quarters of the rating changes were a result of the emphasized consideration of management practices.

This report, while directed primarily at local governments' tax-backed governmental operations, serves as an overview for the entire spectrum of governmental debt issuance, for both tax-supported and user fee-based enterprise operations. It discusses the management practices that Fitch believes are conducive to strong creditworthiness and those that are detrimental to financial soundness. In updating its view on management's effect on creditworthiness, Fitch incorporates an assessment of disclosure and debt affordability practices. For the future, Fitch is in the process of disseminating similar reports for other sectors of public finance, such as health care, transportation, and higher education. Fitch will continue to evaluate and identify best practices and disclosure techniques so that management can be appropriately and objectively evaluated in assigning ratings.

■ Background

Prior to Fitch's default study, rating agencies had always considered financial management practices when assigning bond ratings. Policies that call for contingency operating reserve funds, pay-as you-go capital spending, and multiyear budgeting were encouraged, although their rating value was left vague in rating agencies' guidelines. Likewise, receiving budgeting and financial reporting awards from organizations like the Government Finance Officers Association (GFOA) was generally lauded by rating agencies but given the same indistinct response in assigning ratings. Most rating adjustments for management reasons occurred on a case-by-case basis, rather than based on consistent benchmarks that define management practices' worth in an issuer's ultimate rating assignment.

In analyzing actual financial crises of the past 25 years, it is clear that management has had a significant impact on salvaging, as well as exacerbating, situations. In the 1970s, New York City had more than its share of economic problems, with declining population, employment, and property values. However, its financial crisis was precipitated by cash basis accounting, poor management decisions, lack of internal controls, overspending, and poor record keeping. The default by the Washington Public Power Supply System was as much a result of unrealistic projections as of a national shift from nuclear power generation to conservation as a means of addressing energy shortages. Reliance on nonrecurring revenues and liberal growth forecasts contributed to Nassau County, NY's fiscal crisis in the late 1990s. Finally, the inappropriately speculative investment strategy and lack of internal controls of Orange County, CA caused the huge investment losses that led to the county seeking bankruptcy protection. In most of these cases, questions were raised about whether adequate disclosure practices were employed. Market participants expressed concern that lack of disclosure was a major contributor to the meltdowns, allowing issuers to mask their financial problems until it became too late to mount effective strategies to reverse their fortunes.

On the positive side, fiscal discipline and strong management practices have significantly benefited credits. Baltimore has been faced with long-term economic erosion and urban flight as much as any city in the country. However, its budgets are consistently balanced, and its bond ratings have been kept in the upper end of the 'A' category by all three major rating agencies. The cities of Detroit and New York have also employed management practices that have resulted in enhanced credit quality.

In summary, management practices and policies can add stability to weak credits, maximizing their credit rating potential. Conversely, weak financial management can negatively affect even the strongest economies and local government structures. In extreme cases, poor management can cause rating downgrades to below investment grade and, on rare occasions, bankruptcy or missed debt service payments. The increased pressure for better disclosure by issuers from regulators and municipal analysts is understandable because of the correlation between substandard disclosure and severe fiscal stress and default events.

■ Best Practices and Disclosure Standards

Best practices that promote efficiency in government and solvency in public finance have been identified by the GFOA; The National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Budget Officers; the National Association of Counties; and the International City/County Management Association. In 1997, a group called the National Advisory Council on State and Local Budgeting (NACSLB) was created by these and numerous other government organizations and business leaders. NACSLB published a report in 1998 on approximately 60 best practices in budgeting and financial management for state and local governments. Its recommendations constitute many of the financial management practices that Fitch recognizes as superior and considers in its credit rating process.

Not all NACSLB's best practices deal with financial management; many concern taxpayer communications or assessing programs and services. Fitch believes that if taxpayers understand the services governments provide, they may be less likely to propose restrictive initiatives or force dramatic political or management changes through the electoral process. Coral Springs, FL and Scottsdale, AZ are recognized leaders in the identification of taxpayer concerns, needs, and priorities.

The national debate about increased disclosure by issuers of municipal debt began after New York City's financial crisis in 1975. Many governments still used cash basis accounting to report their operations, and many series of bonds were sold with little more than a four-page notice of sale and bidding instructions. To its credit, New York City fashioned improvements to its financial management system and oversight mechanisms (these were required by the credit markets before market access would be granted to the beleaguered city), which led to the widespread acceptance of generally accepted accounting principles (GAAP) as the minimum standard of financial reporting disclosure for state and local governments. This trend toward increased GAAP use was an important factor in Fitch's conclusion in its 1999 default study that there has been an improvement in safety and stronger creditworthiness in the municipal market.

Although the municipal market still enjoys relative freedom from regulation by the Securities and

Exchange Commission, self-policing structures, like the Municipal Securities Rulemaking Board, exist to ensure that an active debate regarding disclosure practices continues. In recent years, the National Federation of Municipal Analysts (NFMA) led the charge for more detailed disclosure by local governments. This organization issued or drafted comprehensive disclosure guidelines for nine municipal finance sectors and developed secondary market disclosure forms for another eight areas.

Related to the quality and amount of disclosure by issuers is the concept of timeliness. Rule 15c2-12 of the Securities Exchange Act of 1934 is intended to ensure timely disclosure of material events or developments defined by the rule. Annual audited financial reports are generally available within six to nine months after a fiscal year's end, according to accepted practice; however, there is no formal standard for this written into regulation. Rating agencies have a certain amount of influence because the failure to receive an audited financial report can result in the withdrawal or loss of a bond issuer's rating. However, such an action does not help investors make informed decisions; rating withdrawals only result in an absence of information. Fitch believes a delay in reporting that exceeds six to nine months after the close of a fiscal year is excessive.

In recent years, there has been a fair amount of controversy regarding the adequacy and operation of the disclosure repositories. With the expansion of the internet and its widespread acceptance as a means to transfer information, even the smallest issuer has a cost-effective platform for the dissemination and publication of debt disclosure information.

Fitch's last report on management presented a list of positive financial management practices that Fitch felt had the most beneficial effect on creditworthiness. Several of these items touched on disclosure, such as an issuer's receipt of awards for excellence in financial reporting and budgeting. Fitch indicated it would more favorably view ratings for issuers that were already meeting the newer demands for fixed asset and depreciation reporting resulting from Governmental Accounting Standards Board Statement No. 34 (GASB 34). Now that many governments have to meet the fiscal years 2002 and 2003 implementation deadlines for GASB 34, this form of disclosure will increasingly become the accepted standard, rather than the exceptional practice of a few forward-minded issuers. Fitch is updating its list of favorable practices to address the

Best Financial Management Practices for Governmental Issuers

- Fund balance reserve policy/working capital reserves
- Multiyear financial forecasting
- Monthly or quarterly financial reporting and monitoring
- Contingency planning policies
- Policies regarding nonrecurring revenue
- Debt affordability reviews and policies
- Superior debt disclosure practices
- Pay-as-you-go capital funding policies
- Rapid debt retirement policies (greater than 65% in 10 years)
- Five-year capital improvement plan integrating operating costs of new facilities
- Financial reporting awards
- Budgeting awards

broader subject of disclosure, rather than focusing on fixed asset depreciation reporting. The box above lists those financial management practices in the government sector that Fitch believes are most positive in credit analysis.

Fund Balance Reserve Policy/Working Capital Reserves

Maintaining an operating reserve or rainy day fund is perhaps the most effective practice an issuer can use to enhance its credit rating. It is also the most frequently implemented practice, adopted by both large and small local government issuers. A financial reserve may be used to address unanticipated revenue shortfalls or unforeseen expenditures. This provides a first defense against deficit spending and helps maintain liquidity when budgeted drawdowns become inevitable. The appropriate size of such a reserve depends on the potential variability of the entity's revenues and expenses, as well as its working cash needs to handle seasonality of revenues or expenditures.

Governments can issue cash flow notes — tax anticipation notes or revenue anticipation notes — when revenue receipts and/or expenditure disbursements are uneven throughout the fiscal year or mismatched with one another. In such cases, short-term borrowings can be an effective means to even out lumpy or unbalanced cash flows. However, in several instances, governments have issued sizeable amounts of cash flow notes to compensate for unanticipated

year-end cash and fund balance deficits. A need for notes in situations of fiscal stress may indicate weakened credit quality and is a leading cause of downgrades. Issuers that can meet their seasonal cash flow needs from working cash on hand can avoid all the potential problems that issuing notes in finance shortfalls might create.

Multiyear Financial Forecasting

The practice of forecasting operating revenues and expenditures over several years has generally developed from issuers experiencing severe fiscal stress and coming under the oversight of financial control boards, such happened in New York City, Washington, D.C., and Philadelphia. However, in these cases, multiyear financial forecasting has had beneficial effects long after the financial crises passed. A multiyear plan enables executives and legislators to anticipate potential budget stress that may result from projected revenue and expense imbalances, allowing them to take corrective action long before budgetary gaps develop into crises. The multiyear plans of New York City and Philadelphia serve as good models for larger local governments. Multiyear planning for general fund operations can be effectively employed by smaller issuers (with less than 50,000 people) too, such as Radnor Township, PA, at relatively low cost.

Monthly or Quarterly Financial Reporting and Monitoring

Interim financial reporting and monitoring can block the progress of impending fiscal stress if the financial management system is calibrated properly. The best interim reports give details on the issuer's major tax and revenue sources, with variance analysis that shows the factors that are affecting revenue inflow. Likewise, interim reports that present spending for the current month, for the year to date, and in comparison with the budget are also beneficial. For an interim report to be most meaningful, its format and basis of reporting should be consistent with the adopted budget, the past year's GAAP results, or both. The quarterly city manager's report put out by Philadelphia is an example of excellent interim reporting; in addition to providing updates on service delivery and important management initiatives, the report gives quarterly results for general fund operations, adjusted to GAAP and comparable with the city's annual financial statements.

Contingency Planning Policies

When evaluating credits, municipal credit analysts do not like to see surprises, particularly negative ones. Demonstration by an issuer of foresight and planning against unforeseen events is viewed positively. Many future challenges can be anticipated. Each year, in several states, a number of voter initiatives are presented that propose revenue limits or reductions and can potentially change issuers' financial flexibility dramatically. Issuers should have meaningful contingency plans against the possibility of voter-ordered tax cuts. Likewise, issuers located in zones with frequent hurricanes should have reasonable contingency plans for dealing with the financial, economic, and social challenges posed by a storm's destruction. Finally, local governments should consider making contingency plans for their proposed or adopted budgets, in the event that budget assumptions prove erroneous. Simply put, officials should think about creating a plan B. Early planning and timely communication of contingency plans can greatly help maintain creditworthiness in the face of unusual events.

The City of Federal Way, WA is an example of an issuer that employs good contingency planning techniques. In Fitch's 2000 comprehensive review of ratings and management practices, Federal Way was the Fitch-rated issuer with the greatest number of best practices implemented and maintained.

Policies Regarding Nonrecurring Revenue

Overreliance on nonrecurring revenues, or "one shots," to pay ongoing and recurring expenses is a credit concern, since it frequently contributes to budgetary stress and fiscal structural imbalances. One shots can be sales of fixed assets (such as surplus school buildings or properties), budgetary savings from a debt refinancing, court settlements, or tax collection windfalls resulting from state or federal government changes.

From a credit perspective, nonrecurring revenues are best used for one-time or discretionary spending that will not entail spending pressures in future years. Such uses include funding a pension fund's unfunded liability or providing pay-as-you-go capital expenditures, in turn reducing that year's debt issuance by a similar amount.

Knoxville, TN, among several best practices it employs, has adopted prudent fiscal policies regarding the use of nonrecurring revenue. These policies paved the way for an upgrade of the city's rating to 'AA+' in August 2001.

Debt Affordability Reviews and Policies

Strong debt management practices are evidenced by comprehensive debt policy statements that discuss the types and methods of financing employed by an issuer. These should include an issuer's policies regarding off balance sheet financings, such as certificates of participation (COPs) or lease debt, as well as bond anticipation notes, tax and revenue anticipation notes, and variable-rate demand obligations (VRDOs). Conduit debt need not be included unless it draws on taxes and/or fees levied and collected by the issuer as part of traditional government operations. Policy statements should also set forth any self-imposed debt limitations, such as those based on personal income, property market value, or annual recurring revenue or spending. Debt affordability policies, like those of the State of Maryland, Howard County, VA, and many other counties in Virginia and Maryland, are viewed as most valuable in Fitch's debt management analysis.

Also related to debt affordability, an issuer should consider its overall exposure between invested assets and external debt issuance. Increasingly, government issuers are balancing short- and long-term investments with a mix of short- and long-term debt. Fitch recognizes that prudent use of VRDOs and other interest rate risk management tools can benefit the balance sheets and long-term financial health of a tax-exempt debt issuer. However, inappropriate or excessive use of such financial instruments may have the opposite impact. A debt issuer engaged in such practices is encouraged to do so in conjunction with a comprehensive asset-to-liability management policy that includes:

- Identification of debt and investment management products and counterparty ratings acceptable to the debt issuer.
- Expected benefits of selected financial products in light of potential interest rate volatility.
- Strategies for responding to projected and unprojected changes in short- and long-term interest rates.
- Sources of funds available for potential swap termination payments.
- Designation of individuals responsible for negotiating, monitoring, and reporting market conditions and their impact on variable- and fixed-rate debt, interest rate hedges, investments, and any financial products under consideration or already implemented.
- Frequency of marking to market and monitoring investments and other financial products.

The City of Orlando, FL is a leader in the field of asset-to-liability management.

Superior Debt Disclosure Practices

Superior disclosure practices go beyond the documentation required to successfully undertake a new issuance of bonds or notes. Risk managers, analysts, and institutional investors provide a market mechanism that sets disclosure standards for favorable market access. Thus, the true measure of an issuer's disclosure practices comes when it has no future debt plans and holders of its securities are dependent on secondary market disclosure to make informed decisions to buy, sell, or hold debt.

The ongoing requirements of Rule 15c2-12 under the Securities Exchange Act of 1934 are the minimum for disclosure and, in many cases, are limited to calling for audited financial statements and publication of negative developments after they occur. In such cases, an investor may receive important information after the fact, when an issuer is experiencing fiscal stress or in default.

Although many VRDOs are exempt from the continuing disclosure provisions of Rule 15c2-12, superior disclosure practices should incorporate a commitment to ongoing disclosure of material events relating to VRDOs. Such material events include conversion of interest rate modes, mandatory tenders, draws on liquidity or credit facilities, changes in liquidity or credit support providers, significant amendments of bond and bank documents, and termination of related swaps.

For annual financial reports, while GASB 34 sets minimum new disclosure requirements (such as the new management's discussion and analysis section), nothing prohibits an issuer from choosing to disclose additional information. Additional disclosure can be presented in notes to the annual financial statement or in a supplementary information section or statistical section. These sections can contain the data on demographic trends, tax assessments, and utility customers that is found in most comprehensive annual financial reports awarded the GFOA's Certificate of Achievement for Excellence in Financial Reporting. Some larger states and cities have implemented an annual disclosure statement as a companion to the audited report, which basically updates all the key information and statistics originally supplied in new bond issue offering statements. The annual disclosure statement, when

updated, can serve as a section of the new official statement for debt issued during the current fiscal year.

Some examples of superior disclosure that are not standard items in a financial report are:

- Delineation of financial management policies (such as the items listed in this report as best practices).
- Specific histories of pledged tax or revenue streams that back revenue bonds (which many times are obscured due to their inclusion in a larger, more general category such as local taxation).
- Charts depicting required and actual revenue bond coverage, calculated per the bond indenture formulas.
- Operating fund cash flows, broken out monthly, particularly for issuers that externally borrow for seasonal cash flow needs.
- Compliance with key indenture terms, such as covenants, reserve funds, and/or renewal and replacement funds.
- Use of short-term borrowings that occur within a fiscal year but are not reported because they are extinguished before the fiscal year-end audit reporting requirement.
- Use and performance of interest rate swaps, including marked-to-market value, occurrence of events of default or termination, and any termination payments made or received.
- Annual updates of operating data for enterprises, such as fees, customer trends, and service volume.
- Status of VRDOs, including the actual average interest rate paid during the previous year, current credit and/or liquidity support providers, and any plans to convert or swap debt to or from fixed or floating rate.

Fitch prefers that issuers regularly disclose all municipal debt and lease obligations — including general obligation bonds and debt supported by local tax or enterprise revenue sources. Fitch's tax-supported debt ratings take into account the level of all such debt relative to the size of the local tax base. Disclosure of whether any bonds are not fully supported on an annual basis by their intended source of payment (such as a sales tax or gas tax providing at least 1.0 times debt service coverage) is also needed in order for analysts and investors to consider all relevant credit pressures on the municipal entity.

In addition, disclosure of debt issued by off balance sheet entities, including shell leasing companies and

entities created to facilitate securitization of tobacco settlement revenues, is helpful, although the decision of whether to include such debt in tax-supported debt ratios will vary, based on, among other factors, the intended source of debt payment, the receipt of legal opinions clarifying the recourse of off balance sheet bondholders to government resources, and whether pledged revenues are owned by the rated municipality. *(For more information on tobacco-related off balance sheet entities, see Fitch Research on "Revised Treatment of Tobacco Bonds in Government Debt Ratings," dated March 1, 2001, available on Fitch's web site at www.fitchratings.com.)*

Issuers considering improvements to their ongoing disclosure practices can find suggestions and examples in several places. Two good sources are the guidelines promulgated by the GFOA for its Certificate of Achievement for Excellence in Financial Reporting Program and the secondary market disclosure guidelines adopted and published by the NFMA.

A leader in the use of the internet as a means of ongoing disclosure is the City of Philadelphia, which incorporates copies of its annual financial report, annual budget in brief, and five-year financial plan for tax-supported funds on its web site.

Pay-As-You-Go Capital Funding Policies

In terms of credit analysis, the benefits of pay-as-you-go capital funding are several and profound. First, significant funding of capital costs from annual budget appropriations helps keep an issuer's debt low, which is always a positive credit factor. Second, pay-as-you-go capital appropriations improve an issuer's financial flexibility in the event of a sudden revenue shortfall or emergency spending. A temporary shift away from pay-as-you-go funding for recurring expenditures is not automatically viewed as negative if the issuer historically has demonstrated a propensity to return to pay-as-you-go funding when possible. In future years, some issuers may choose to increase their pay-as-you-go appropriations in response to GASB 34 (depreciation of general assets). Such a move would have positive implications for a local government credit. Finally, contribution of capital pay-as-you-go appropriations for a project financed with COPs provides insight on the leased project's essentiality to the issuer. Providing a substantial downpayment from annual resources demonstrates the government's commitment to the project and encourages the issuer to keep annual rent payments current so as not to lose the contributed capital of the pay-as-you-go appropriation through a

COP default and the project being taken over by a receiver or trustee.

Chattanooga, TN is a leader in using pay-as-you-go contributions for capital projects, which has allowed the city to keep its debt burden manageable despite a major downtown redevelopment project over the past two years.

Rapid Debt Retirement Policies

One tenet in credit analysis is that the life of debt should not exceed the useful life of the asset or project being financed. However, useful life should not be the only benchmark considered when structuring the maturity of an issuer's debt. An issuer that frequently sells 30-year debt or continually extends the existing maturities of its debt through refinancing and restructuring may still manage to match debt to useful life. However, from a credit perspective, an issuer that pays off its debt rapidly (65% or more of principal in 10 years) will be analyzed more favorably than a similar issuer that retires only 50% of its debt over 10 years. Retiring less than 35% of tax-backed debt in 10 years is considered a weak fiscal practice.

Of further credit value, rapid debt retirement usually results in a declining debt service schedule, thereby providing additional financial flexibility and debt capacity for future years. Issuers that stretch out their debt through ascending debt service maturities or heavy use of capital appreciation bonds reduce their financial flexibility. Back-ended debt can raise concern, particularly if repayment is expected to come from future revenue growth that may not be realized.

Hamilton County, TN restricts the final maturities on its tax-supported debt to 15 years, resulting in a debt amortization rate of 89% over the next 10 years. This gives the county a great deal of flexibility for future debt issuance, and the declining debt service schedule that results incorporates budgetary flexibility to meet rising service costs in other areas.

Five-Year Capital Improvement Plan that Integrates Operating Costs of New Facilities

The practice of creating a multiyear capital improvement plan has reached such widescale acceptance that absence of a plan may be viewed as a credit negative. Plans of the more sophisticated and foresighted government managers not only project future debt issuance but include the incremental operating costs of newly built facilities. Generally,

five years is a good planning time frame, although for some communities, a longer range plan may be appropriate. Integrating future operating costs for capital construction in a capital plan implies that the issuer does multiyear forecasting for its operating fund. Doing both of these is viewed as cutting edge, contributing to more favorable rating consideration.

Since the early 1980s, New York City's four-year financial plan has incorporated not only the future debt costs for its capital plan, but the future capital plant operating costs in its four-year operating fund forecasts.

Financial Reporting and Budgeting Awards

Awards for excellence in financial reporting and budgeting are granted by the GFOA and, to school districts, by the Association of School Business Officials International (ASBO). Receipt of these awards does not imply financial strength; the City of Philadelphia continued to receive such awards in the early 1990s, when it was near bankruptcy. However, an issuer's achieving these awards gives investors and credit analysts increased confidence that the information disclosed in its financial reports and budgets is comprehensive and accurate.

Frequently, reporting items beyond those required by the GFOA and ASBO standards is helpful in fully describing an entity's financial operations. Additional items may include details of major operating fund transfers in and out and a breakdown of revenues categorized as taxes into specific components. Issuers that regularly disclose the management and internal control assessments received from their auditors are recognized as making the best efforts to present full and complete disclosure to rating agencies and other industry credit analysts.

Oak Ridge, TN has garnered the most GFOA awards over the 57 years of the GFOA's financial reporting award program and 18 years of its budget award program, with 57 (40 for its annual reports and 17 for its budgets). The cities of Boca Raton, FL, Eugene, OR, Fort Worth, TX, and San Antonio, TX and Montgomery County, OH are tied for the greatest number of GFOA budgeting awards, each with 18.

■ Accounting for Depreciation of General Governmental Fixed Assets

GASB 34 requires issuers to account for and report use and depreciation of capital assets not reported in utility enterprise funds. Initially, it seems local

governments that did not fund depreciation of such assets on a pay-as-you-go basis are likely to report annual operating deficits in the new governmentwide financial statements under the new accounting model, even if all other normal expenses are funded or exceeded by normally recurring revenues. Because of the newness of GASB 34, Fitch does not expect to downgrade issuers in the near term due to deficits resulting solely from new depreciation expenses for general infrastructure, provided that the normal revenue and expenditure balance in the general operating fund continues and the liquidity and financial position of the general fund is not compromised. However, as depreciation accounting becomes more standardized and accepted, Fitch and other municipal credit analysts will expect governments to account for infrastructure maintenance in compliance with GASB 34 requirements and to take actions to keep their infrastructures in good repair.

Orlando, FL reported its fiscal 1999 financial operations in accordance with the GASB '34 guidelines, several years before the deadline for cities of its size.

■ Best Practices and Their Impact on Debt Ratings

Historically, analysts have given only limited weight to best practices when assessing a government's credit. Their concern was always that when economic conditions turn tough, government financial managers may loosen their standards and policies, reverting to acts of fiscal or political expediency to maintain or increase services without raising taxes.

However, after reviewing the historical performance data, it is clear that most issuers that garnered executive and legislative support for best practices did not discard their policies when revenues fell short of budget. Furthermore, the discipline that these issuers adopted as part of long-range financial management improvements helped them during tough times. While some such issuers' fund balances were drawn down, they were rarely fully depleted. For some, pay-as-you-go financing was curtailed temporarily, but generally resumed when revenue collection improved. Also, self-imposed debt affordability restraints were generally not abandoned during recession. Rather, best practices provided such issuers with a steady set of guidelines to see them through troubled economic times, shored up investor confidence, and assured continued access to the debt markets. As such, Fitch believes it is appropriate to

explicitly give greater weight in the credit rating process to such standards.

Record bankruptcies in the corporate world, combined with past fiscal meltdowns in the state and local government sector, all serve to demonstrate that poor disclosure practices can magnify and lengthen fiscal stress, if not actually contribute to the fiscal problems. Superior disclosure practices help issuers to form capital and avoid financial stress before it occurs.

Assessing management can be very subjective; one analyst's view of what constitutes strong managers may substantially differ from another's. However, the management practices cited in this report are all tangible evidence of good management and, in one form or another, have been viewed positively by credit analysts in the public finance sector. Recognition of management practices, rather than merely managers, helps provide an objective means to assess this sector in credit analysis.

The best practices beneficial to an issuer's creditworthiness are weighted in the table below. Fitch's rating process assesses an issuer's achievement of these best practices, and the more of these practices an issuer uses, the more rating enhancement is possible. Those practices considered most valuable are labeled "very significant," on down to "significant" and "influential." Many of these practices have been used by managements of issuers that received 'AAA' ratings from Fitch in the past. In

Relative Values of Best Practices in Fitch's Public Finance Ratings

| Best Practice | Value* |
|--|------------------|
| Fund balance reserve policy/working capital reserves | Very Significant |
| Multiyear financial forecasting | Significant |
| Monthly or quarterly financial reporting and monitoring | Significant |
| Contingency planning policies | Influential |
| Policies regarding nonrecurring revenue | Influential |
| Debt affordability reviews and policies | Very Significant |
| Superior debt disclosure practices | Very Significant |
| Pay-as-you-go capital funding policies | Significant |
| Rapid debt retirement policies (greater than 65% in 10 years) | Significant |
| Five-year capital improvement plan integrating operating costs of new facilities | Influential |
| Financial reporting awards | Influential |
| Budgeting awards | Influential |

*Values in descending order of importance are: very significant, significant, and influential.

future reviews, these practices will be important criteria for new 'AAA' assignments.

■ Practices that Cause Concern

Listed in the box at right are some practices that raise analysts' concern about an issuer's fiscal future. Many are familiar or self-explanatory. In a future report, Fitch will examine these practices and other negative developments that have caused and will continue to produce negative concern and lower debt ratings.

■ Management Is Key to Ratings in the 21st Century

Management analysis, as well as new viewpoints on the analysis of local economies and special tax pledges, formed the cornerstone of Fitch's revised rating guidelines for tax-backed debt originally published in May 2000. The rash of bankruptcies of companies like Enron Corp. and WorldCom highlights the role that poor disclosure can play in distressed situations. Fitch feels that its approach to factoring in management and disclosure practices will serve as a standard for credit analysis in the age of the internet and rapidly expanding technology. As always, Fitch welcomes comment and debate from other interested parties, whether issuers, analysts, investors, or academics.

Worst Financial Management Practices for Governmental Issuers

- Cash basis accounting
- Qualified audit opinion of material weakness
- Deficit financing for two of past five years
- Slow debt retirement (less than 35% in 10 years)
- Unfunded accrued pension liability (funding ratio less than 60%)
- Tax and revenue anticipation note amount growing significantly faster than annual spending
- Debt restructuring that defers more than 35% of current debt service
- Overreliance on nonrecurring revenue (for more than 15% of recurring expenses)
- Aggressive investment policy for operating funds
- Pension contribution deferral in the current budget year
- Budgetary impasse beyond legal completion date
- Lack of capital improvement plan
- Excess interfund borrowing with no capacity to repay in near future

Copyright © 2002 by Fitch, Inc. and Fitch Ratings, Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified, and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at any time for any reason at the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services Act of 1986 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.